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February 14, 2011

AGENDA ITEM 3

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** 2011 Real Estate Strategic Plan
- II. PROGRAM:** Real Estate
- III. RECOMMENDATION:** Recommend approval of the Real Estate Program's Strategic Plan.
- IV. ANALYSIS:**

Staff requests the Investment Committee's approval of the Real Estate Strategic Plan which includes key recommendations and an implementation timeline.

Summary and Recommendations

The following is a summary of the recommendations in the Real Estate Strategic Plan:

1. Invest in private Real Estate equity
2. Focus majority of portfolio on United States
3. Implement new role of Real Estate by splitting program into Legacy Portfolio and New Portfolio
4. Organize New Portfolio into three sub portfolios (Base, Domestic Tactical, International Tactical)
5. Reduce overall risk profile by requiring a minimum of 75% of the portfolio to be Core
6. Utilize moderate leverage across the portfolio, with emphasis on Debt Service Coverage Ratio in addition to Loan to Value Ratio
7. Utilize separate account structure as primary business model
8. Replace existing benchmark (An Investment Committee agenda item on all benchmarks is planned for March)

The proposed timetable to implement the Real Estate Strategic Plan is provided on page 4 of this agenda item.

List of Attachments:

- Attachment 1 - Proposed 2011 Strategic Plan for Real Estate
- Attachment 2 - Pension Consulting Alliance Opinion Letter
- Attachment 3 - Wilshire Associates Opinion Letter

Background

As required by the Real Estate Unit's (REU) policy, staff and the Board's Real Estate Consultant, Pension Consulting Alliance (PCA), shall develop and present a new proposed Strategic Plan (Plan) at a minimum every five years. The Investment Committee approved the current Plan in September 2007. As a result of the recent Asset Liability Management review process, the role of real estate has changed. The prior role of real estate included return enhancement as well as diversification. The new role of real estate includes low correlation to equities, stable cash yields, and partial inflation hedge.

Given the changing role of real estate in the CalPERS portfolio, staff and PCA are proposing a revised Plan. Staff has been working closely with the Investment Strategy Group (ISG), PCA, and other stakeholders over the past several months to complete the proposed Plan.

Listed below is a summary of the 2011 Real Estate Strategic Plan recommendations and corresponding recommendations from the current 2007 Plan.

1. Invest in private real estate equity

- Staff is evaluating Real Estate Investment Trusts (REITs) to determine role in the Total Fund
- Global Equities continues to hold REITs as a share of the equity benchmarks
- Current Plan: Includes private real estate equity (90%) and public real estate (10%)

2. Focus majority of portfolio on United States

- For a small percentage of the portfolio, focus on international growth markets with limited exposure to Western Europe and Japan
- Current Plan: Targets 50% international investments

3. Implement new role of real estate by splitting program into Legacy Portfolio and New Portfolio

- Legacy Portfolio is comprised of assets that do not fit within the new role of real estate
- New Portfolio will be comprised of assets which fit the new role for real estate

- 4. Organize New Portfolio into three sub portfolios (Base, Domestic Tactical and, International Tactical)**
 - Base – Produce predictable cash flows
 - Domestic Tactical – Extension of existing Core Program with focus on total return
 - International Tactical – Generate appreciation by capitalizing on growth
 - Current Plan: Organizes assets by risk categories only (Core, Value-Add and Opportunistic)

- 5. Reduce overall risk profile by requiring a minimum of 75% of the portfolio to be Core**
 - Reduce overall risk profile to core plus
 - Current Plan: Overall risk profile is value-add

- 6. Utilize moderate leverage across the portfolio, with emphasis on Debt Service Coverage Ratio as well as Loan to Value Ratio**
 - Maintain current policy limit on subscription financing and recourse debt
 - Current Plan: Emphasis is on Loan to Value Ratio

- 7. Utilize separate account structure as primary business model**
 - Balance of moderate fees, alignment of interest, and control
 - Current Plan: Utilize separate account structure

- 8. Replace existing benchmark with NCREIF Fund Index – Open End Diversified Core (ODCE)**
 - Proposed benchmark is a composite of Open-end Funds with \$73 billion of assets, before and after fee returns are reported, moderate leverage
 - Benchmarks, and transitioning to new Benchmarks, will be discussed further in the March Investment Committee item; Fund Policy Benchmarks
 - Current Plan: Two benchmarks; 1) A minimum real rate of return of 5.0%; and, 2) A blended benchmark of NCREIF Property Index plus 200 basis points (90%) and FTSE EPRA NAREIT Global Real Estate Index (10%)

Implementation Timeline

If approved, the following timeline outlines the actions staff will undertake to begin implementation of the Real Estate Strategic Plan.

IMPLEMENTATION ACTION	EXPECTED TIMING
A. 2011 Real Estate Strategic Plan presented to the Investment Committee for approval.	February 2011
B. Staff presents review of all benchmarks, including Real Estate, to Investment Committee.	March 2011
C. Staff proposes revised Real Estate Policies and Delegated Authority to the Investment Policy Subcommittee and Investment Committee.	2 nd Quarter 2011
D. Staff reclassifies existing real estate investments into new portfolios.	2 nd Quarter 2011
E. Staff provides reports on the progress of the Strategic Plan implementation.	Quarterly

Board Real Estate Consultant Review

PCA has reviewed and concurs with staff's recommendation. PCA will be available at the Investment Committee meeting to answer any questions Committee members may have regarding the Strategic Plan.

V. STRATEGIC PLAN:

The 2011 Real Estate Strategic Plan will further the following CalPERS Strategic Plan goals:

- Goal VIII. Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.
- Goal IX. Achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

At this time the Investment Office does not anticipate any additional cost needed to implement the Strategic Plan.

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Members of the Investment Committee
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